BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE, OF CALIFORNIA

In the Matter of the Appeal of)
)
CALIFORNIA CONTRACT COMPANY)

Appearances:

For Appellant: Archibald M. Mull, Jr., and Contrad T. Hubner, Attorneys at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of California Contract Company to proposed assessments of additional franchise tax in the amounts of $3,374.79, $1,808.13 and $2,037.31 for the income years ended July 31,1953,1954 and 1955, respectively.

Fred L. Waters conducted a coin machine business in Oakland under the name of Coin Play Amusement Company. Bingo pinball machines, flipper pinball machines, shuffle alleys and miscellaneous amusement machines were placed in some 15 locations. On July 9, 1952, Waters executed a bill of sale to transfer title to the equipment, the good will and the business name to Appellant.

Thereafter Waters, or his employee, continued to make collections and repairs. For a time, Waters remitted to Appellant two-thirds of the amounts collected. Later, the remittances were reduced to 60 percent and finally to one-half. Waters bore his own expenses except that Appellant furnished any repair parts needed. Waters did not inform the location owners that he was acting for Appellant.

Early in 1954 Waters notified Appellant's president that he desired to terminate the arrangement. Thereupon another individual, Harrison Terry, was secured to make collections from and repairs to the machines on the route. Appellant paid Terry a weekly salary of $100 from which it deducted amounts for unemployment, social security and income taxes. Like Waters, Terry did not inform the location owners that he was acting for Appellant.

Respondent determined that Appellant was the route operator subsequent to July 9, 1952, that Appellant was renting space in the locations where its machines were placed, and that

all the coins deposited in the machines constituted gross income to Appellant. Respondent also disallowed all expenses pursuant to Section 24436 (24203 prior to June 6, 1955) of the Revenue and Taxation Code which reads:

> In computing net income, no deductions shall be allowed to any taxpayer on any of its gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deduction be allowed to any taxpayer on any of its gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

We must first decide whether the collector (Fred L. Waters or his successor) or Appellant was the principal involved in the operation of the machines. There is no serious question with respect to Terry, the successor to Waters. He was clearly an employee of Appellant. As to the arrangement with Waters, Appellant's president testified that it was an oral lease for an indefinite term. Waters, on the other hand, testified that he managed the route for Appellant. The matter is not free from doubt, but the fact that Appellant had purchased from Waters not only the machines but also the trade name and good will indicates to us that Appellant was the principal and we so hold.

The evidence indicates that the operating arrangements between Appellant and each location owner were the same as those considered by us in Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par. 58145. Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of the machines is, accordingly, applicable here.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par. 201-984, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code Sections 330b, 330.1 and 330.5 if the machine is predominantly a game of chance or if cash is paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance.

The bill of sale executed on July 9, 1952, is in evidence and lists 45 machines in 15 locations. At least 15 of these machines were identified as bingo pinball machines and were in 7 different locations.

The list of locations and equipment furnished by Appellant in Nay, 1956, is also in evidence and shows 46 machines in 18

locations. At least 29 of these machines in 9 of the locations were identified as bingo pinball machines.

Three individuals who made the actual collections during the period in question testified that it was the general practice for location owners having pinball machines to claim amounts from the proceeds of the machines for expenses and that the balance was divided with the location owner.

There was received in evidence a notebook compiled by a collector for the period from November, 1953, to February 1954. This notebook showed for each location three columns of figures designated respectively as "total," "payoff" and "split." In most instances there were substantial amounts recorded in the "payoff" column, an average of 38 percent of the "total." In a few instances the "payoff" column was left blank or contained a relatively nominal amount.

We conclude that it was the general practice to pay cash to players of the pinball machines for unplayed free games. Accordingly, the pinball machine phase of the business was illegal both on the ground of ownership and possession of bingo pinball machines which were predominantly games of chance, and on the ground that cash was paid to winning players. Respondent was therefore correct in applying Section 24436.

Since the same individual made collections from and repairs to all machines on the route, there was a substantial connection between the illegal operation of pinball machines and the legal operation of shuffle alleys and miscellaneous amusement machines and it was proper to disallow all the expenses of the coin machine business.

Appellant's reported gross income did not include the amounts retained by the collectors. Respondent treated these amounts as part of Appellant's gross income. This was proper in view of our finding that Appellant was the principal involved in the operation of the machines.

Appellant's reported gross income did not include the cash payouts to winning players. There were not complete records of such amounts. Respondent computed the cash payouts on the basis that they averaged 33-1/3 percent of the coins deposited in all types of machines. This percentage was derived from partial records obtained from Fred L. Waters.

Appellant has offered no evidence that this percentage was excessive. It was reasonable under the circumstances and is sustained.

Appellant also owned a building in Oakland from which it obtained rental income. When Respondent's auditor was denied access to Appellant's records, Respondent disallowed the expenses attributable to this building. Respondent concedes that the expenses for insurance, interest, depreciation and property taxes attributable to this building are allowable deductions subject to Respondent being granted access to Appellant's records to verify the amounts. Appellant has agreed to the examination of records.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of California Contract Company to proposed assessments of additional franchise tax in the amounts of $3,374.79, $1,808.13 and $2,037.31 for the income years ended July 31, 1953, 1954 and 1955, respectively, be modified in that the gross income and disallowance of expenses are to be recomputed in accordance with the opinion of the Board.

Lone at Sacramento, California, this 10th day of January, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary